ActewAGL
for you

19 December 2013

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SOUTH SYDNEY NSW 1235
Lodged online at www.aemc.gov.au

Dear Mr Pierce

Response to AEMC Consultation Paper on Distribution Network Pricing Arrangements

Thank you for the opportunity to respond to the AEMC's *Consultation Paper, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014*. ActewAGL Distribution recognises the potential benefits of cost-reflective tariffs and has progressively introduced a range of network tariff options incorporating time-of-use, capacity and demand charges to signal the economic costs of supply. We also appreciate the importance of engaging and sharing information with our customers, so that they can understand and respond to our network tariffs, and we can understand and respond to their needs and preferences.

While we support initiatives to encourage more efficient supply and use of electricity, we are concerned that several aspects of the proposed rule changes are overly prescriptive and may limit the flexibility that DNSPs need to develop network tariffs that meet the needs of their customers and address the issues facing their particular networks.

Our responses to the consultation paper are provided in the attached submission. ActewAGL Distribution looks forward to continuing engagement with the AEMC during the review of the rule change proposals. Please contact Leanne Holmes, Manager Economic Regulation, on 0412 850715 if you would like to discuss any aspect of our submission.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing

ActewAGL Distribution response to network pricing rule change proposals

Submission to the Australian Energy Market Commission

19 December 2013

1 Introduction

ActewAGL Distribution welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC's) *Consultation Paper, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014* (consultation paper). ActewAGL Distribution is a public-private partnership owned equally by ACTEW Distribution and Jemena Networks. ActewAGL Distribution owns the electricity distribution network in the ACT and gas distribution networks in the ACT and the adjoining areas of New South Wales and in Shoalhaven.

ActewAGL Distribution is a member of the Energy Networks Association (ENA) and supports the ENA's comprehensive submission on the consultation paper. The ENA submission contains industry responses to each of the 46 questions raised in the consultation paper. This submission provides further comments on matters of particular concern for ActewAGL Distribution.

Within the framework provided by the current distribution pricing rules, ActewAGL Distribution has developed a range of cost reflective tariffs which include time-of-use and demand or capacity components. More that 50 per cent of the total load in the ACT (and 80 per cent of the non-residential load) is now subject to time-of-use or controlled load (off-peak) charges. Time-of-use tariffs have been the default tariffs for all new customers since October 2010. The application of maximum demand and capacity tariffs in most of our commercial tariff options has further strengthened incentives for efficient use of the network resulting in improved load factors. The tariff structure is subject to ongoing review to ensure that the needs and preferences of our customers are met and any emerging network issues are addressed in the most efficient and effective way.

The proposed rules would result in significant changes to the way network tariffs are set and the structure and levels of prices faced by customers. As the AEMC notes in the consultation paper, the proposed changes, and particularly the requirement to base tariffs on long run marginal cost (LRMC), would likely "create greater uniformity amongst DNSPs' approach to network pricing across NEM" and could "reduce flexibility and scope for innovation".[1]

ActewAGL Distribution does not support changes which would result in greater prescription and less pricing flexibility for distribution network service providers (DNSPs). Networks across the national electricity market (NEM) come from very different starting points (for example, current tariff structures and levels vary widely), have different customer bases, network characteristics and cost drivers, and face different challenges and issues. Diverse circumstances and issues require specific responses. DNSPs need flexibility to determine how to set prices to best meet the current and future needs of their customers, and to respond to the challenges and opportunities created by new technologies for energy supply and use.

[1] AEMC 2013, *Consultation paper, National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014* (Consultation paper), p. 57

2 Tariff setting and approval processes

The proposals of both the Standing Council on Energy and Resources (SCER) and the Independent Pricing and Regulatory Tribunal (IPART) involve significant changes to distribution network tariff setting and approval processes. The proposals seek to achieve:

- Greater consultation on the development of network tariffs; and
- A greater level of pricing certainty with respect to changes to network tariff structures and network tariff pricing levels.[2]

The proposed Pricing Structures Statement (PSS), developed in advance of the annual network pricing process, would play a central role in achieving these objectives.

ActewAGL Distribution appreciates the importance of an open and transparent process for developing network tariffs. We consider that the purpose of consultation and engagement should be two-fold:

- to provide consumers and retailers with information on tariff structures and levels to allow them to respond and make informed decisions; and
- to allow DNSPs to better understand and respond to the preferences, needs and views of consumers and retailers.

ActewAGL Distribution agrees that providing information on proposed tariff structures in a PSS, as part of the regulatory determination process, could play a useful role in informing consumers and retailers and providing an opportunity for consultation.

However, we are concerned that the proposed new framework for tariff setting and approval is overly prescriptive and goes well beyond the high level framework that would be required to meet the objectives of informing customers and facilitating consultation. In broad terms, we consider that the PSS must not bind DNSPs to approved tariff structures and levels over the 5 year regulatory period. Consultation requirements should not place an inflexible burden on DNSPs and customers, but instead be geared to the circumstances – for example, more intensive consultation in cases where significant tariff changes are proposed.

Specific comments on the nature and content of the PSS and the potential consultation requirements are provided below.

[2] AEMC 2013, Consultation paper, p. 27

2.1 The role of the Pricing Structures Statement (PSS)

As the AEMC explains in the consultation paper, the role and impact of the PSS depends on:

- *Content* – the amount of detail the document contains on network tariff structures and network tariff pricing levels; and
- *How binding it is* – how often the document is able to be varied and the extent to which the DNSP can move away from the network tariff structures contained in the document in its annual pricing proposal.[3]

In relation to content the AEMC asks:

> *Q. 2: What level of information on network tariff structures and network tariff pricing levels should be included in a network tariff structures document to assist retailers and consumers to understand and respond effectively to changing prices and structures over the regulatory period?*

ActewAGL Distribution considers that the PSS should provide information on proposed tariff structures and indicative tariffs for the regulatory period. The purpose should be to provide consumers, retailers and other stakeholder with an indication of expected pricing over the period, given the information available at that time.

It is not possible, or reasonable, to provide price certainty for consumers and retailers over the 5 year period. The network tariffs that customers face depend on a range of factors which cannot be accurately predicted and are generally beyond the control of the DNSPs – for example, transmission charges, jurisdictional scheme payments, cost pass through amounts. In addition, new issues may emerge during the regulatory period, requiring tariff responses. For example, in response to the dramatic growth in the installation of rooftop photovoltaic (PV) systems over the past 5 years, ActewAGL Distribution and other DNSPs are reviewing their tariff structures.[4]

ActewAGL Distribution does not support SCER's proposal to require more detailed information in the PSS, such as proposed recovery of residual revenue and an explanation of how the pricing meets the pricing principles[5], as these more detailed matters are appropriately addressed through the annual network pricing process. The PSS should primarily be a document which informs customers and provides a basis for consultation.

In relation to how binding the PSS should be, ActewAGL Distribution's position is that:

- DNSPs must have the flexibility to vary network structures during the period. As noted above, over a 5 year regulatory period new issues may arise requiring changes to tariff structures, for the benefit of DNSPs and their customers.

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[3] AEMC 2013, Consultation paper, p. 30

[4] See for example *Air conditioners and solar – why electricity pricing needs to be reformed*, esaa discussion paper, October 2013

[5] AEMC 2013, Consultation paper, p. 33

- If, during the regulatory period, a DNSP proposes to depart significantly from the indicative structures set out in the PSS it should explain the reasons in the annual pricing proposal. The proposal should be assessed for compliance with the pricing principles.
- If a DNSP proposes to depart significantly from the PSS (for example by introducing a new tariff likely to apply to a large proportion of customers), then it should explain to the AER, in the annual pricing proposal, how it has consulted with relevant stakeholders, consistent with the AER's consumer engagement guidelines (discussed further below).

In relation to the PSS, and the scope for tariff changes during a regulatory period, the AEMC also asks:

> *Q. 3: How often are network tariff structures likely to change during a regulatory period and what are some of the reasons for that change?*

ActewAGL Distribution's experience indicates that the nature and frequency of changes will vary across periods and be driven by a range of factors. For example, in the previous regulatory period (2004-09) ActewAGL Distribution introduced 2 major changes to tariff structures – capacity charges for low voltage commercial customers and time-of-use charges for residential customers.

Changes in the current regulatory period (2009-14) have not involved changes to tariff structures (that is, new tariffs or new tariff components), but instead changes to the application of the existing tariffs. For example, time-of use tariffs became the default tariffs for all new customers in 2010; the option to have electric vehicles metered separately from normal residential load was introduced in 2011; and the buy-back arrangements for customers with small PV systems (less than 30kW) were changed in 2013. The ability to make these changes requires flexibility to provide cost reflective price signals and to respond to new technologies, such as electric vehicles and the growth of rooftop PV systems.

2.2 Consultation

ActewAGL Distribution places great importance on engaging with customers and understanding their preferences. We have devoted considerable efforts to better understanding customer preferences, using state-of-the-art choice modelling studies to understand customers' willingness to trade changes in the level of network prices with changes in various service attributes relating to supply reliability, supply quality, and undergrounding.

Consultation can take many different forms. ActewAGL Distribution considers that any consultation requirements should not be overly prescriptive, and should provide DNSPs with flexibility to determine how to best engage with retailers and consumers. The importance of taking into account jurisdictional circumstances when setting consultation requirements was noted by the Australian Government in its June 2013 response to the Productivity Commission's

Electricity Network Regulatory Frameworks Final Report.[6] ActewAGL Distribution agrees that the appropriate nature and extent of consultation will depend on the circumstances. The AER's consumer engagement guideline also "allows flexibility in how the service providers develop a better understanding of their consumer base and consumer issues."[7] ActewAGL Distribution supports this approach.

In the consultation paper the AEMC asks:

> *Q. 11: Should the AER be required to provide guidance on the consultation process for DNSPs? Should the guidelines be binding on the DNSPs?*

ActewAGL Distribution considers that the recently released consumer engagement guidelines provide the appropriate high level framework for consultation in relation to pricing. The guidelines are not binding. The AER has already identified "making price and reliability trade-offs" and "setting and designing tariffs (including time of use and critical peak tariffs)" as potential topics of engagement.[8] A new set of guidelines is not required.

3 Pricing principles

ActewAGL Distribution agrees that cost-reflective network pricing is important for encouraging efficient supply and use of electricity. The appropriate structure and level of network prices will depend on a range of factors such as the relevant network cost drivers, the characteristics and preferences of consumers, and implementation costs such as metering costs. These factors will vary across networks, so flexibility in network price setting is critical.

Recognising this, the current National Electricity Rules (clause 6.18) contain a set of high level pricing principles, rather than prescription on how prices must be set. The current distribution pricing rules were developed following extensive analysis and consultation and reflect the position that they should be:

- Sufficiently high level as to allow for the various operating contexts of different DNSPs across Australia; and
- Not too prescriptive in the Rules.[9]

[6] Australian Government 2013, *Response to the Productivity Commission Inquiry Report*, June, p. 23

[7] AER 2013, *Explanatory statement to the consumer engagement guideline for network service providers*, November, p. 13

[8] AER 2013, *Explanatory statement to the consumer engagement guideline for network service providers*, November, p. 19

[9] Network Policy Working Group 2006*, Distribution Pricing Rule Framework*, December, p. 4

As noted earlier in this submission, within the current high level pricing framework ActewAGL Distribution has progressively introduced a range of cost-reflective tariff options. Other DNSPs have also introduced or trialled various innovative tariff options, to suit their circumstances[10]

ActewAGL Distribution does not believe that SCER has established that the proposed changes to the pricing principles will result in better pricing outcomes, when all the relevant costs and benefits of implementing the changes are taken into account. This is particularly so for the proposed new requirement for prices to be "based on" LRMC.

3.1 LRMC as the basis for setting network tariffs

In the consultation paper the AEMC says:

> *Under SCER's proposal, DNSPs will have to demonstrate that their proposed network tariffs are based on LRMC. This is likely to help in facilitating the use of time-based pricing and create greater uniformity amongst DNSPs' approach to network pricing across the NEM. It is also likely to provide more certainty for retailers and consumers around the basis for network pricing. On the flipside, it could reduce flexibility and scope for innovation in DNSP pricing, as well as the ability of DNSPs to tailor their pricing to their specific circumstances.*[11]

This comment raises several of the concerns we have about the proposed move to pricing based on LRMC:

- What does pricing "*based on*" LRMC mean in practical terms? The proposed rules seem to allow for departures from strict LRMC pricing, with DNSPs to "have regard to" other listed factors. However the overall requirements are unclear and would involve considerable compliance risk for DNSPs. We believe that the current requirement to "take account of" LRMC is appropriate.
- A related issue is: what measure of LRMC is appropriate? The AEMC provides a definition which suggests a highly disaggregated approach, as it refers to costs "to meet a particular user's sustained incremental derived demand".[12] SCER's proposal also refers to the need to have regard to differences in LRMC by location and time of day.[13] This highly disaggregated approach is likely to result in significant costs (discussed further below), and it is not clear that there will be significant offsetting benefits for all networks. As demonstrated by the modelling presented in the *Power of Choice* review,

[10] See for example the discussion of flexible pricing options in the AEMC's *Power of Choice Final Report*, chapter 6

[11] AEMC 2013, Consultation paper, p. 57

[12] AEMC 2013, Consultation paper, p. 58

[13] AEMC 2013, Consultation paper, p. 60

the potential benefits of more cost reflective pricing are likely to vary widely across jurisdictions.[14]

- The AEMC comments that LRMC pricing is likely to help in *facilitating the use of time-of-use pricing*. We believe that where time-of-use pricing has not been applied, there are generally good reasons, related to the likely costs and benefits of time-of-use pricing, including metering, price elasticity of demand and consumer preferences.
- This suggests that a broader approach needs to be taken, as proposed by the ENA, to address the reasons why cost reflective pricing has not been more widely applied. A central part of this integrated approach must be retail price deregulation. This would remove any unnecessary constraints on market based outcomes and allow pricing flexibility and innovation in retail pricing. Informing customers about the benefits of more cost-reflective pricing options is also a vital part of the integrated approach. Cost reflective transmission pricing, providing signals on the costs of losses and capacity constraints, must also be part of an integrated approach to more efficient pricing.[15]
- The AEMC also comments that the LRMC proposal is also likely to result in *greater uniformity*. As noted in our comments above, we believe that uniformity is not appropriate, given the diversity of cost drivers and network and customer characteristics across the NEM.
- The AEMC also identifies *more certainty for retailers and consumers around the basis for network pricing* as a likely outcome of SCER's LRMC proposal. As noted above, ActewAGL Distribution considers that the PSS could play a role of in providing more information and guidance on the proposed basis and structure of prices. However, we believe that the proposed requirement for tariffs to be based on LRMC, at a highly disaggregated level and with other factors to be taken into account, may result in less certainty and more complexity for consumers and retailers.

In the consultation paper the AEMC asks:

> *Q. 21: What would be the likely impacts on customers of making a LRMC approach mandatory?*
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> *Q. 22: What would be the impacts on DNSPs of making an LRMC approach mandatory? Does it result in increased compliance risk?*

ActewAGL Distribution considers that customers (consumers and retailers) would face more complex prices and potentially less certainty under mandatory LRMC pricing, particularly if the prices differ by location and time (of day and season). The mandatory requirement is also likely to require significant changes in prices from current levels for some customer classes.

[14] AEMC 2013, *Power of Choice Final Report*, chapter 10

[15] Transgrid has commented that while SCER's rule change proposal relates to distribution pricing, "SCER's observations regarding the long-term benefits of efficient network pricing apply equally to transmission" (see *Transgrid, Consultation Paper: Transmission Pricing*, November 2013, p. 3)

For retailers subject to price regulation, LRMC based network pricing, potentially including different location elements, would create additional complexity and costs where standard offers have to be prepared and approved. Retailers are also likely bear at least some of the costs of customer resistance to significant changes in network tariff structures and levels.

In terms of impacts on DNSPs, as noted above we believe that the proposal to make LRMC pricing mandatory would involve additional compliance risk. It would also involve a significant compliance burden, particularly if the proposed requirements to base prices on costs "for particular users" and taking account of different locations and times, are strictly applied.

The AEMC also asks whether "one methodology should apply to calculating LRMC or should multiple methodologies be allowed" (Q. 25) and whether the AER should be "required through a guideline to specify the methodology or methodologies of calculating and applying LRMC" (Q. 26).

ActewAGL Distribution believes that different methods should be allowed, and any AER guideline should provide guidance only, and not be binding.

As the AEMC notes, there are several possible models and approaches for calculating LRMC. The results are generally very sensitive to the model adopted and the assumptions made. ActewAGL Distribution's experience with LRMC estimates in the 2009-14 regulatory period demonstrates that model results are sensitive to factors such as the stage the DNSP is at in the investment cycle – for example, a major "lumpy" investment will significantly influence the LRMC estimates. Results therefore need to be interpreted carefully and in the context of overall network development. It is therefore appropriate for prices to be informed by and take account of LRMC, but not necessarily strictly based on LRMC.

3.2 Other pricing principles and requirements

SCER proposes several other new requirements, in addition to the LRMC principle. As noted in our comments above, ActewAGL Distribution is concerned about the potential uncertainty and compliance risk associated with these unclear and potentially conflicting requirements.

One of the additional requirements relates to recovery of residual costs. ActewAGL Distribution believes that this is a critical requirement, particularly in the context of declining and highly uncertain electricity consumption. DNSPs need the flexibility to set tariffs in a way that allows them to fully recover their efficient costs, consistent with the revenue and pricing principles in the National Electricity Law (NEL).[16]

The AEMC says:

> *"SCER has not sought to propose a particular pricing approach in its rule change request. Rather, it has requested the AEMC to consider what mechanism for recovering residual costs would be*

[16] NEL clause 7A

most appropriate (postage stamp, Ramsey pricing or an alternative approach). SCER has also noted that should the AEMC consider that a single approach is not appropriate for all jurisdictions or distribution network areas, it could also consider whether the AER should be given the discretion to determine the best approach at the time of making a regulatory determination." [17]

The AEMC asks:

Q. 34: Should an approach or approaches be specified in the NER or an AER guideline?

ActewAGL Distribution believes that an approach should not be specified in the rules. The AER could prepare a guideline, for DNSPs to use as guidance when developing their proposed approach to recovery of residual costs. This could be set out in the annual pricing proposal.

The AEMC also raises the issue of the pass through of transmission charges:

Q. 40: Should network tariffs reflect transmission pricing signals? If so, what would be the most appropriate way to achieve this for different types of network customers?

ActewAGL Distribution considers that DNSPs should have the flexibility to determine how they allocate transmission charges. We have commented in a previous submission to the AEMC on the problems with the current pricing signals in transmission use of system (TUoS) charges.[18] DNSPs should not be required to preserve and pass on inefficient transmission pricing signals in their network tariffs.

SCER's rule change proposal also involves changes to the operation of side constraints. The proposal to apply side constraints across regulatory periods (that is, in year one of each regulatory period) is of particular concern for ActewAGL Distribution. We appreciate the importance of managing potential price adjustments for customers. However, as recognised in the current rules (where side constraints do not apply in year one), larger price adjustments may be necessary between periods to allow DNSPs to recover at least the efficient costs of providing their services. Restricting these adjustments and limiting the scope for revenue recovery would be inconsistent with the revenue and pricing principles in the NEL.[19]

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[17] AEMC 2013, Consultation paper, p. 17

[18] ActewAGL Distribution 2012, response to AEMC second interim report, Transmission frameworks review, November.

[19] NEL clause 7A

4 Transitional arrangements

In the consultation paper the AEMC says:

> *Any new rules that are made are likely to apply to the pricing processes in 2015. This would include those for the New South Wales, ACT, Queensland and South Australian distribution businesses. The new rules would not apply to pricing processes that are completed in 2014. Transitional rules would be required if new rules are to be applied to the revenue determinations to be made by the AER in 2015.*[20]

In table 7.1 the AEMC indicates that the earliest time the PSS process could apply to the ACT and New South Wales DNSPs, subject to the need for transitional arrangements, would be the 2015/16 regulatory year. ActewAGL Distribution does not agree that this timeframe for the introduction of PSS requirements is feasible or reasonable.

The proposed PSS process is intended to be part of the 5-yearly regulatory determination process. The PSS would be submitted as part of the regulatory proposal, following consultation with customers, and reviewed as part of the determination process which, following amendments to the chapter 6 rules in November 2012, is now spread over 17 months.

ActewAGL Distribution's regulatory proposal for the 2014-19 regulatory period is to be submitted to the AER in May 2014, 6 months *before* the AEMC's final determination on the pricing rule change is scheduled to be completed in November 2014. Under the timetable in table 7.1, the consultation that is integral to the PSS process and intended to be undertaken as part of the regulatory determination process would have to be undertaken in the few months between November 2014 and the due date for the 2015/16 annual pricing proposal (which may be 1 April 2015, depending on the outcomes from this rule change proposal). Instead of trying to rush the implementation of the PSS in 2015/16, the rules should require it to be introduced at the start of the next full regulatory determination process. However, if the AEMC does not accept this and decides to apply new PSS requirements during the already commenced regulatory periods, transitional arrangements must be included to explicitly allow a shorter and less comprehensive PSS process.

In the consultation paper the possible need for transitional arrangements is discussed in the context of the PSS (in chapter 7). ActewAGL Distribution considers that the need for transitional arrangements must also be carefully examined in relation to the other part of the rule change proposal – the proposed changes to the pricing principles. The proposed changes to the pricing principles are likely to result in significant changes to the structure and level of network tariffs. DNSPs and their customers cannot be expected to become fully compliant with the new rules from the first pricing approval process after November 2014. The proposed changes are complex and will take time to implement, and the current barriers to LRMC pricing such as metering

[20] AEMC 2013, Consultation paper, p. ii

technology will remain for some time. These factors need to be recognised in transitional arrangements, if the proposed rules are implemented.